



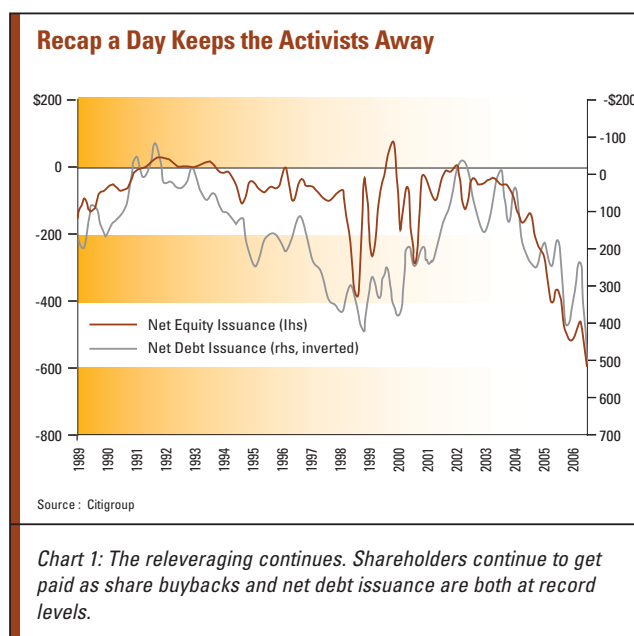
Serve the Juice!

During a recent family vacation to the Caribbean, it occurred to me that the current wave of activist shareholders are behaving much like a group of bratty children.

What triggered the realization? After a long day of sun and sand and with their heads full of pirates and buried treasure, my three children sat with their two cousins, pounded their little fists on the table, and demanded that the adults “Serve the juice!”

This new breed of hedge funds and corporate raiders are behaving in exactly the same way, demanding that companies “serve the juice” – return value to their shareholders – or else. But unlike children who are overdue for a nap, this uprising of shareholder activism is not easily quelled; in fact, it’s spreading around the globe. These activists will not take no for an answer. Names like Bill Ackman of Pershing Square Management LP, Nelson Peltz of Trian Fund Partners Inc., Carl Icahn, Greenlight Capital Inc., and Pirate Capital are at the forefront of the movement. These people, and others like them, are waking up passive shareholders and putting companies on notice, so shareholders, managements and lenders had best pay attention.

The activists see themselves as the ultimate defenders of shareholders’ rights as they rebel against the passivity of traditional institutional shareholders who have been willing to put up with languishing stock prices for years. The aim, of course, is to seek out ways to make relatively quick returns by pressuring companies to come up with creative ways to increase their share prices. They are saying to companies: “reorganize yourself, or we’ll do it to you.”



Like predators and scavengers, activists play a crucial role in the capitalistic ecosystem. As their numbers grow, they are accelerating the pace at which the natural processes of capitalism occur – the death and decomposition of the weak. Activists are targeting underperforming companies that have failed to maximize the potential of their asset base.

Their strategy typically involves a variety of measures including:

- asset sales
- business unit spin-offs
- debt-funded share buybacks
- special dividends

- closures of money-losing units
- and, the outright auction of the entire business.

If managements don't concede to their demands, activist shareholders put forth their agenda to other shareholders and engage in proxy battles to take control of the board. In some cases, the activist will partner with like-minded investors and bid for the entire company.

This year, we have seen an activist-inspired recapitalization virtually every day. Under-leveraged companies are responding to shareholder pressure and borrowing to buy back shares. This leveraged buyback has become a popular defensive strategy against activist attacks. Chart 1 shows that debt issuance and equity repurchase activity are at record levels.

In the current environment, the cost of borrowing is low and after several years of solid profits, companies have little or no debt. For many, the financial rationale behind a debt recapitalization is sound, from both a tax and cost of capital standpoint.

The combination of low default rates and low long-term interest rates has resulted in extraordinarily favourable borrowing conditions for corporations. Companies are responding to this intelligently by adding debt in their capital structure to achieve a lower-weighted average cost of capital. (See chart 2).

Late last year, Barron's published a list of companies that were rumoured to be LBO targets. Among them were two Signature positions, Noble Energy Inc. and Grainger Inc. Since then, Noble has bought back more than 7.5% of its shares and Grainger has increased its dividend by more than 20%, as well as buying back 10% of its outstanding shares. As prime candidates for activists, both were forced into taking action and returning value to shareholders. In many respects,

this new corporate mantra of providing tangible rewards to shareholders, at the expense of reinvestment, was first seen in the Canadian income trust market as companies converted from corporations to trusts and shareholders staked their claim on corporate cash.

Another good example is the case of Wendy's International Inc. In 2005, hedge fund managers Nelson Peltz of Trian and Bill Ackman of Pershing Square pressured Wendy's management into spinning off Tim Hortons Inc., selling company-owned restaurants to franchisees, and expanding the board of directors to include three new directors chosen by Peltz.

As the largest Canadian shareholder of Wendy's, we knew the company was underperforming and that the value of Tim Hortons was underestimated and unrealized. At the time, we were contemplating approaching management with a proposal to spin off Tim Hortons as an income trust, but Peltz and Ackman beat us to the punch.

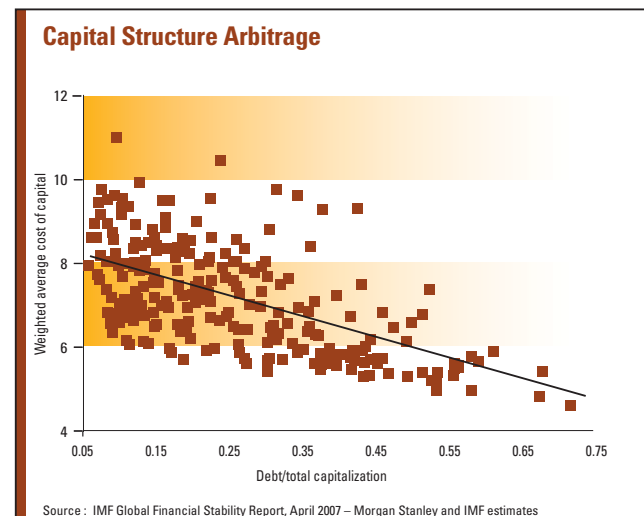


Chart 2: This chart shows that firms for which debt forms a higher proportion of their total capitalization tend to have a lower weighted average cost of capital – a result of relatively low interest rates. Therefore, the current wave of buyouts can be seen as “capital structure arbitrage” in which firms with capital structures with relatively less debt may become targets.



Currently, there are two scenarios playing out on the global corporate stage.

In Europe, Dutch bank ABN Amro was put into play by the Children's Investment Fund, which owned just 1% of its shares. This London-based activist hedge fund put pressure on ABN to consider a sale or break-up of the bank after several years of underperformance. In late April, British bank Barclays agreed to purchase ABN Amro for about US\$91 billion. As part of the deal, ABN also agreed to sell its Chicago-based LaSalle Bank to Bank of America for an additional US\$21 billion in cash. A sale will make it the world's biggest bank acquisition.

Here at home, BCE is on the block. This development emerged from the frustration of BCE's largest shareholder, Ontario Teachers' Pension Plan (OTPP) that the stock had gone nowhere for nearly eight years. OTPP's public contemplation of making a bid for all of BCE was the activist event that pushed the company into an auction.

At time of writing, it appeared that a consortium of four partners, including the Canada Pension Plan Investment Board, Caisse de dépôt et placement du Québec and the Public Sector Pension Investment Board, along with New York-based Kohlberg Kravis Roberts & Co., the largest private equity firm in the world, would make a bid for BCE. The final price tag of the leveraged buyout is expected to be more than \$30 billion – the largest Canadian deal ever.

Emboldened activists are turning their sights on Citigroup and General Electric, two underperforming giants. These challengers won't be satisfied with a simple 10% dividend increase. It seems anything is possible in the realm of the activist investor. Many of these reorganizations wouldn't be possible without the high level of private equity activity in the market today.

Shareholders are the winners from all this activity as they are rewarded by special dividends and higher stock prices. Lenders are the losers as leveraged companies face credit downgrades and lower bond prices.

The wasted investment of the late 1990s has spawned a new and unprecedented culture of financial discipline that is being enforced by the activists. Managements face intense pressure to justify capital allocation decisions, with the new default action being to "serve the juice" to shareholders. Positions are shifting as management supremacy is gradually gives way to shareholder supremacy, with activist investors leading the charge. The battles have just begun and years of investor rewards lie ahead.

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